

**1994 ANNUAL REPORT OF THE BOARD OF
TRUSTEES OF THE FEDERAL HOSPITAL
INSURANCE TRUST FUND**

COMMUNICATION

FROM

**THE BOARD OF TRUSTEES, FEDERAL
HOSPITAL INSURANCE TRUST FUND**

TRANSMITTING

**THE 1994 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE
FEDERAL HOSPITAL INSURANCE TRUST FUND, PURSUANT TO
SECTION 1817(b) OF THE SOCIAL SECURITY ACT, AS AMENDED**



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LETTER OF TRANSMITTAL

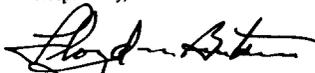
BOARD OF TRUSTEES OF THE
FEDERAL HOSPITAL INSURANCE TRUST FUND
Washington, D.C., April 11, 1994

HONORABLE THOMAS S. FOLEY
Speaker of the House of Representatives
Washington, D.C.

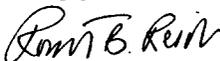
HONORABLE ALBERT GORE, JR.
President of the Senate
Washington, D.C.

GENTLEMEN: We have the honor of transmitting to you the 1994 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund (the 29th such report), in compliance with the provisions of section 1817(b) of the Social Security Act.

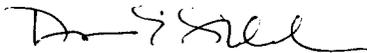
Respectfully,



LLOYD M. BENTSEN,
*Secretary of the Treasury, and
Managing Trustee of the Trust Fund*



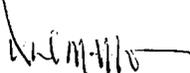
ROBERT B. REICH,
Secretary of Labor, and Trustee



DONNA E. SHALALA,
*Secretary of Health and Human Services,
and Trustee*



STANFORD G. ROSS,
Trustee



DAVID M. WALKER,
Trustee



BRUCE C. VLADECK,
*Administrator of the Health Care
Financing Administration, and
Secretary, Board of Trustees*

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I. OVERVIEW

A. SUMMARY

1. Operations of the Hospital Insurance Program

The hospital insurance (HI) program pays for inpatient hospital care and other related care for those age 65 and over, and for the long-term disabled. In calendar year 1993, HI covered about 32 million aged and about 4 million disabled enrollees at a cost of \$94.4 billion. Of this amount, \$93.5 billion was for benefit payments and \$0.9 billion, 1 percent of total disbursements, was for administrative expenses.

The HI program is financed primarily by payroll taxes, with the taxes paid by current workers and their employers used mainly to pay benefits for current beneficiaries. Income not currently needed to pay benefits and related expenses is held in the HI trust fund. The assets of the fund may not be used for any other purpose. While in the fund, the assets are invested in certain interest-bearing obligations of the United States Government. These obligations are backed by the full faith and credit of the U.S. Government.

The payroll taxes of 138 million workers and their employers amounting to \$84.1 billion, or 85.7 percent of total income to the fund, were collected during calendar year 1993. Interest income from investments held by the trust fund amounted to 10.8 percent of total income. The remaining 3.5 percent of calendar year 1993 income consisted mostly of a transfer from the railroad retirement program, a transfer from the Supplementary Medical Insurance (SMI) catastrophic coverage reserve fund, transfers to and from the general fund of the Treasury, and premiums paid by voluntary enrollees.

The HI contribution rates applicable to taxable earnings are 1.45 percent for employees and employer each and 2.90 percent for self-employed. The maximum taxable amount of annual earnings for 1993 was \$135,000. After 1993, the maximum taxable annual earnings amount is eliminated.

The adequacy of the HI program's scheduled financing to support program costs in the future is examined under three alternative sets of assumptions: low cost, intermediate, and high cost. The intermediate set of assumptions represents the Trustees' best estimate of the expected future economic and demographic trends that will affect the financial status of the program. The low cost alternative is a more optimistic set of assumptions from the standpoint of HI financing and the high cost alternative is a more pessimistic

Overview

set of assumptions. The trust fund ratio, defined as the ratio of assets at the beginning of the year to disbursements during the year, was 131 percent in 1993 and then under the intermediate assumptions is projected to decline steadily until the fund is completely exhausted in 2001. Under the low cost assumptions, the trust fund ratio is projected to decline until the fund is completely exhausted in 2004. Under the high cost assumptions, the trust fund ratio is projected to decrease rapidly until the fund is exhausted in 2000. These projections clearly demonstrate that the HI program is severely out of financial balance using a range of plausible economic and demographic assumptions.

Table I.C4 in this report summarizes the estimated operations of the HI trust fund that have just been described under the three alternative sets of assumptions. As can be seen from this table, the Trustees' short-range test of financial adequacy, which is described in the "Expected Operations and Status of the Trust Fund" (section I.C), is not met. In addition, the trust fund is projected to become insolvent within the next 6 to 10 years under all three sets of assumptions.

The adequacy of the current law financing schedule for the HI program on a long-range basis is measured by comparing on a year-by-year basis the income rates (from payroll taxes and income from taxation of OASDI benefits) with the corresponding incurred costs of the program, expressed as percentages of taxable payroll. However, the financial status of the program is often summarized, over a specific projection period, by a single measure known as the actuarial balance. The actuarial balance using the present-value method is defined to be the difference of the sum of the present values of the income rates for the valuation period over the sum of the present value of the cost rates (insured, incurred costs expressed as a percentage of taxable payroll) of the program for the same period, divided by the sum of the present values of the effective taxable payroll for the valuation period. The "Actuarial Status of the Trust Fund" (section I.D) describes the method used to calculate summarized cost rates, income rates, and actuarial balances. The HI trust fund does not meet the Trustees' long-range test of financial adequacy, as discussed in section I.D, under any of the three sets of assumptions.

Table I.A1 presents a comparison of the projected experience contained in the 1993 and 1994 reports. As this table indicates, the projections in the 1994 report show that the fund will be depleted later than projected in the 1993 report under all three sets of assumptions. The major reason for this

difference is the legislation enacted since the 1993 report, as described in the technical section. Section I.D discusses in more detail the reasons for the change in the actuarial balance. Compared to last year's report, under the Trustees' intermediate assumptions, the date of exhaustion will be 2 years later and the 75-year actuarial balance will improve by 0.97 percent of taxable payroll.

Table I.A1. -- STATUS OF THE HI TRUST FUND

Sets of assumptions	Year in which the trust fund is exhausted as published in the		75-year actuarial balance of the HI program as published in the	
	1993 report	1994 report	1993 report	1994 report
Intermediate	1999	2001	-5.11%	-4.14%
Low cost	2000	2004	-2.04	-1.31
High cost	1998	2000	-10.61	-9.26

2. Conclusion of the Board of Trustees

Under the Trustees' intermediate assumptions, the present financing schedule for the HI program is sufficient to ensure the payment of benefits only over the next 7 years. Also, the HI trust fund does not meet the Trustees' short-term test of financial solvency. Under the high cost alternative, the fund is projected to be exhausted in 2000, approximately 6 years from the present. Under the low cost alternative, the trust fund is projected to be exhausted in 2004.

Currently about four covered workers support each HI enrollee. This ratio will begin to decline rapidly early in the next century. By the middle of that century, only about two covered workers will support each enrollee. Not only are the anticipated reserves and financing of the HI program inadequate to offset this demographic change, but under all the assumptions, the trust fund is projected to become exhausted even before the major demographic shift begins to occur. As noted above, exhaustion of the fund is projected to occur around the turn of the century under all three sets of assumptions.

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The Trustees note that some steps have been taken to reduce the rate of growth in payments to hospitals, including the implementation of prospective payment and diagnosis-related groups. Initial experience under the prospective payment system for hospitals suggests that this payment mechanism may be an effective means of constraining the growth in hospital payments and improving the efficiency of the hospital industry. Nonetheless, projected costs for the HI program far exceed projected revenues over the 75-year long-range period. As a result, the HI program is severely out of financial balance and is unsustainable in its present form.

Even though the long-range status of the HI program has improved somewhat since last year's report, it has deteriorated over recent years as measured by the actuarial balances. In addition, the HI trust fund fails to meet the short-range test of financial adequacy and is projected to experience increasing annual deficits in future years, beginning in calendar year 1996. In view of the poor financial condition of the HI trust fund and the failure of the fund to meet the short-range test of financial adequacy, the Board of Trustees is again alerting the Congress of the unfavorable financial status of the HI trust fund.

The cost of the HI program is projected to increase from 1.5 percent of Gross Domestic Product (GDP) in CY 1993 to 4.9 percent of GDP in CY 2065. This rapid growth is attributable primarily to (1) increases in hospital admissions, (2) increases in reported case mix, and (3) changes in demographics. With the magnitude of the projected actuarial deficit in the HI program and the high probability that the HI trust fund will be exhausted around the turn of the century, the Trustees urge the Congress to take additional actions designed to control HI program costs through specific program legislation and as a part of enacting comprehensive health care reform. The Trustees believe that prompt, effective, and decisive action is necessary.

B. THE BOARD OF TRUSTEES

The Federal Hospital Insurance Trust Fund, established on July 30, 1965, is held by the Board of Trustees under the authority of section 1817(b) of the Social Security Act, as amended. The Board is composed of five members, three of whom serve in an ex officio capacity: the Secretary of the Treasury, the Secretary of Labor, and the Secretary of Health and Human Services. The President nominated and the Senate confirmed Stanford G. Ross and

David M. Walker to be the other two members, who serve as representatives of the public. Mr. Ross and Mr. Walker are serving 4-year terms that began on October 2, 1990.

By law, the Secretary of the Treasury is designated as the Board Chairperson and Managing Trustee, and the Administrator of the Health Care Financing Administration is designated as Secretary of the Board. The Board of Trustees reports to the Congress each year on the operations and status of the trust fund, in compliance with section 1817(b)(2) of the Social Security Act. This annual report, for 1994, is the 29th such report.

C. EXPECTED OPERATIONS AND STATUS OF THE TRUST FUND

Table I.C1 shows the expected operations of the trust fund during fiscal years 1994 to 1996, together with the past experience of the program. The estimates shown in this table are based on the intermediate set of assumptions. The assumptions underlying the intermediate projections are presented in the technical section.

Income received through the financial interchange between the railroad retirement account and the trust fund under the provisions of the Railroad Retirement Act is estimated on the same basis as income from HI contributions. Estimates of the corresponding outgo are included in the disbursement items.

Estimated income to the trust fund which is appropriated from general revenue to reimburse the program for the cost of coverage of noninsured persons is the same as the estimates of disbursements incurred for such persons, net of corrections for differences between costs and amounts transferred for previous years. Premium income for other noninsured persons who may enroll in the HI program on a voluntary basis is estimated based on projected premium rates calculated according to statute and estimated average enrollment.

The transfers from general revenue for military wage credits are based on provisions of the Social Security Amendments of 1983 (Public Law 98-21), as described in the technical section.

Overview

The investment of new assets received during fiscal years 1994-96 is assumed to be in the form of special public-debt obligations bearing interest rates ranging from 5.625 percent to 6 percent, payable semiannually. The average effective annual rate of interest on the assets held by the HI trust fund on September 30, 1993, was 8.6 percent.

Disbursements for benefits are projected to increase in fiscal years 1994-96, primarily as a result of the increase in hospital payment rates and hospital admissions under the program. The expenditures for benefit payments shown in Table I.C1 will differ from those shown in the President's proposed 1995 Federal Budget. These estimates are based on more recent demographic and economic projections, and they do not reflect the implementation of proposed changes in regulations which were included in the budget. The expenditures for benefit payments shown in this section are based on the assumption that for fiscal years 1995 and later, the prospective payment rates will be increased in accordance with Public Law 103-66, the Omnibus Budget Reconciliation Act of 1993; for fiscal year 1994, the prospective payment rates have already been determined in accordance with the same statute.

The actual operations of the HI program are organized, in general, on a calendar year basis. Earnings subject to taxation and the applicable tax rates are established by calendar year, as are the inpatient hospital deductible and other cost-sharing amounts. The projected operations of the trust fund on a calendar year basis are shown in Table I.C2, according to the same assumptions as used in Table I.C1. The ratios of assets in the trust fund at the beginning of each calendar year to total disbursements during that year are shown in Table I.C3 for past years and as projected, under the same assumptions, through 1996.

TABLE I.C1.-OPERATIONS OF THE HI TRUST FUND DURING FISCAL YEARS 1970-96
(in millions)

Fiscal year ¹	Income										Disbursements			Trust fund	
	Payroll taxes	Income from taxation of benefits	Railroad retirement account transfers	Reimbursement for uninsured persons	Premiums from voluntary enrollees	Payments for military wage credits	Interest and other income ²	Total income	Beneficial Payments ³	Administrative expenses ⁴	Total disbursements	Net increase in fund	Fund at end of year		
Historical Data:															
1970	\$4,785	-	\$64	\$617	-	\$11	\$137	\$5,614	\$4,804	\$149	\$4,953	\$661	\$2,677		
1975	11,291	-	132	481	\$6	48	609	12,568	10,353	259	10,612	1,966	9,870		
1980	23,244	-	244	697	17	141	1,072	25,415	23,790	497	24,288	1,127	14,490		
1981	30,425	-	276	659	21	141	1,341	32,863	28,907	353	29,260	3,603	18,063		
1982	34,390	-	351	808	25	207	1,829	37,611	34,343	521	34,864	2,747	20,840		
1983	36,387	-	358	878	26	3,663 ⁵	2,629	43,940	38,102	522	38,624	-7,121 ⁶	13,719		
1984	41,364	-	351	752	35	250	2,812	45,563	41,476	633	42,108	3,455	17,174		
1985	46,490	-	371	766	38	86	3,182	50,933	47,841	813	48,654	4,103 ⁷	21,277		
1986	53,020	-	364	566	40	-714 ⁸	3,167	56,442	49,018	667	49,685	17,370 ⁹	38,648		
1987	57,820	-	368	447	40	94	3,982	62,751	49,967	836	50,803	11,949	50,596		
1988	61,901	-	364	475	42	80	5,148	68,010	52,022	707	52,730	15,281	65,877		
1989	67,527	-	379	515	42	86	6,567	75,116	57,433	805	58,238	16,878	82,755		
1990	70,655	-	367	413	113	107	7,908	79,563	65,912	774	66,687	12,876	95,631		
1991	74,655	-	352	605	367	-1,011 ¹⁰	8,969	83,938	68,705	934	69,638	14,299	109,930		
1992	80,978	-	374	621	484	86	10,133	92,677	80,784	1,191	81,974	10,703	120,633		
1993	83,147	-	400	367	622	81	12,484 ¹¹	97,101	90,738	866	91,604	5,497	126,131		
Estimates¹²:															
1994	90,734	1,640	401	506	777	72	10,668	104,798	103,212	1,347	104,559	239	126,370		
1995	100,200	4,218	400	462	876	67	10,566	116,789	112,580	1,434	114,014	2,775	129,145		
1996	106,362	4,498	402	284	958	690 ¹³	10,364	123,558	123,427	1,527	124,954	-1,396	127,749		

- ¹Fiscal years 1970 and 1975 consist of the 12 months ending on June 30 of each year, fiscal years 1980 and later consist of the 12 months ending on September 30 of each year.
- ²Other income includes recoveries of amounts reimbursed from the trust fund which are not obligations of the trust fund and a small amount of miscellaneous income.
- ³Includes costs of Peer Review Organizations (beginning with the implementation of the Prospective Payment System on October 1, 1983).
- ⁴Includes costs of experiments and demonstration projects.
- ⁵Includes the lump sum general revenue transfer of \$3,456 million, as provided for by section 151 of P.L. 98-21.
- ⁶Includes loan to the OASI trust fund of \$12,437 million.
- ⁷Includes repayment of loan principal from the OASI trust fund of \$1,824 million.

- ⁸Includes the lump sum general revenue adjustment of -\$805 million, as provided for by section 151 of P.L. 98-21.
- ⁹Includes repayment of loan principal from the OASI trust fund of \$10,613 million.
- ¹⁰Includes the lump sum general revenue adjustment of -\$1,100 million, as provided for by section 151 of P.L. 98-21.
- ¹¹Includes \$1,805 million transfer from the SMI catastrophic coverage reserve fund, as provided for by P.L. 102-394.
- ¹²Under the intermediate assumptions.
- ¹³Includes \$625 million preliminary estimate of the lump sum general revenue adjustment provided for by section 151 of P.L. 98-21.

NOTE: Totals do not necessarily equal the sums of rounded components.

TABLE I.C2.—OPERATIONS OF THE HOSPITAL INSURANCE TRUST FUND DURING CALENDAR YEARS 1970-96

(In millions)

Calendar year	Income										Disbursements			Trust fund	
	Payroll taxes	Income from taxation of benefits	Railroad retirement account transfers	Reimbursement for uninsured persons	Premiums from voluntary enrollees	Payments for military wage credits	Interest and other income ¹	Total income	Benefits Payments ²	Administrative expenses ³	Total disbursements	Net increase in fund	Fund at end of year		
Historical Data:															
1970	\$4,881	-	\$66	\$863	-	\$11	\$158	\$5,979	\$5,124	\$157	\$5,281	\$698	\$3,202		
1975	11,502	-	138	621	\$7	48	664	12,980	11,315	266	11,581	1,399	10,517		
1980	23,848	-	244	697	18	141	1,149	26,097	25,064	512	25,577	521	13,749		
1981	32,959	-	276	659	22	207	1,603	35,725	30,342	384	30,726	4,999	18,748		
1982	34,586	-	351	808	24	207	2,022	37,998	35,631	513	36,144	-10,583 ⁴	8,164		
1983	37,259	-	358	878	27	3,456 ⁵	2,593	44,570	39,337	540	39,877	4,693	12,858		
1984	42,288	-	351	752	33	250	3,046	46,720	43,257	629	43,887	2,834	15,691		
1985	47,576	-	371	766	41	-719 ⁶	3,362	51,397	47,580	834	48,414	4,808 ⁷	20,499		
1986	54,583	-	364	566	43	91	3,619	59,267	49,758	664	50,422	19,458 ⁸	39,957		
1987	58,648	-	368	447	38	94	4,469	64,064	49,496	793	50,289	13,775	53,732		
1988	62,449	-	364	475	41	80	5,830	69,239	52,517	815	53,331	15,908	69,640		
1989	68,369	-	379	515	55	86	7,317	76,721	60,011	792	60,803	15,918	85,558		
1990	72,013	-	367	413	122	-993 ⁹	8,451	80,372	66,239	758	66,997	13,375	98,933		
1991	77,851	-	352	605	432	89	9,510	89,839	71,549	1,021	72,570	16,269	115,202		
1992	81,745	-	374	621	522	86	10,487	93,836	83,895	1,121	85,015	8,821	124,022		
1993	84,133	-	400	367	675	81	12,531 ¹⁰	98,187	93,487	904	94,391	3,796	127,818		
Estimates¹¹:															
1994	93,409	1,640	401	506	811	72	10,637	107,476	105,789	1,362	107,151	325	128,143		
1995	101,841	4,218	400	462	897	692 ¹²	10,485	116,995	115,134	1,458	116,592	2,403	130,546		
1996	107,690	4,498	402	284	978	65	10,187	124,104	126,163	1,550	127,713	-3,609	126,937		

- ¹ Other income includes recoveries of amounts reimbursed from the trust fund which are not obligations of the trust fund and a small amount of miscellaneous income.
- ² Includes costs of Peer Review Organizations (beginning with the implementation of the Prospective Payment System on October 1, 1983).
- ³ Includes costs of experiments and demonstration projects.
- ⁴ Includes loan to the OASI trust fund of \$12.437 million.
- ⁵ The lump sum general revenue transfer, as provided for by section 151 of P.L. 98-21.
- ⁶ Includes the lump sum general revenue adjustment of -\$905 million, as provided for by section 151 of P.L. 98-21.

- ⁷ Includes repayment of loan principal from the OASI trust fund of \$1,824 million.
- ⁸ Includes repayment of loan principal from the OASI trust fund of \$10,613 million.
- ⁹ Includes the lump sum general revenue adjustment of -\$1,100 million, as provided for by section 151 of P.L. 98-21.
- ¹⁰ Includes \$1,805 million transfer from the SMI catastrophic coverage reserve fund, as provided for by P.L. 102-394.
- ¹¹ Under the intermediate assumptions.
- ¹² Includes \$625 million preliminary estimate of the lump sum general revenue adjustment provided for by section 151 of P.L. 98-21.

NOTE: Totals do not necessarily equal the sums of rounded components.

TABLE I.C3. -- RATIO OF ASSETS IN THE FUND AT THE BEGINNING OF THE YEAR TO DISBURSEMENTS DURING THE YEAR FOR THE HI TRUST FUND
(In percent)

Calendar Year	Ratio
Historical Data:	
1967	28%
1968	25
1969	43
1970	47
1971	54
1972	47
1973	40
1974	69
1975	79
1976	77
1977	66
1978	57
1979	54
1980	52
1981	45
1982	52
1983	20
1984	29
1985	32
1986	41
1987	79
1988	101
1989	115
1990	128
1991	136
1992	136
1993	131
Estimates ¹ :	
1994	119
1995	110
1996	102

¹Under the intermediate assumptions.

Since future economic, demographic, and health care usage and cost experience may differ considerably from the intermediate assumptions on which the cost estimates were based, projections have also been prepared on the basis of two different sets of assumptions labeled "Low Cost" and "High Cost." The assumptions used in preparing projections under the low cost and

high cost alternatives, as well as under the intermediate assumptions, are discussed in the technical section.

The three sets of assumptions were selected in order to indicate the general range in which the cost of the program reasonably might be expected to fall. The low cost and high cost alternatives provide for a fairly wide range of possible experience. Actual experience may be expected to fall within the range, but no assurance can be made that this will be the case, particularly in light of the wide variations in experience that have occurred since the beginning of the program.

The estimated operations of the HI trust fund during calendar years 1993-2004, on a cash basis for all program income and disbursements, are summarized in Table I.C4 for all three alternatives until the trust fund is exhausted. The trust fund ratio, defined as the ratio of assets at the beginning of the year to disbursements during the year, was 131 percent in 1993 and then under the intermediate assumptions is projected to decline steadily until the fund is completely exhausted in 2001. Under the low cost alternative, the trust fund ratio is projected to decline until the fund is exhausted in 2004. Under the high cost alternative, the trust fund ratio is projected to decrease rapidly until the fund is exhausted in 2000. These projections do not reflect any reduction in disbursements due to proposed changes in legislation or regulation which were included in the 1995 Federal Budget but which have not been enacted or implemented.

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**TABLE I.C4. -- ESTIMATED OPERATIONS OF THE HI TRUST FUND DURING
CALENDAR YEARS 1993-2004, UNDER THREE SETS OF ASSUMPTIONS**
(Dollar amounts in billions)

Calendar Year	Total Income	Total disbursements	Net Increase in fund	Fund at end of year	Ratio of assets to disbursements ¹ (percent)
INTERMEDIATE:					
1993 ²	\$98.2	\$94.4	\$3.8	\$127.8	131
1994	107.5	107.2	0.3	128.1	119
1995	119.0	116.6	2.4	130.5	110
1996	124.1	127.7	-3.6	126.9	102
1997	129.4	138.8	-9.4	117.5	91
1998	134.7	151.3	-16.6	100.9	78
1999	139.9	165.2	-25.3	75.6	61
2000	145.3	180.5	-35.2	40.4	42
2001	150.7	197.2	-46.4	(3)	20
LOW COST:					
1993 ²	\$98.2	\$94.4	\$3.8	\$127.8	131
1994	108.2	107.0	1.2	129.0	119
1995	119.8	115.5	4.4	133.4	112
1996	127.2	125.5	1.7	135.1	106
1997	134.0	135.2	-1.2	134.0	100
1998	141.1	145.8	-4.7	129.3	92
1999	148.1	157.3	-9.2	120.1	82
2000	155.3	169.4	-14.1	106.0	71
2001	162.5	182.1	-19.6	86.4	58
2002	169.4	195.2	-25.8	60.6	44
2003	176.6	208.9	-32.2	28.4	29
2004	183.7	223.1	-39.4	(4)	13
HIGH COST:					
1993 ²	\$98.2	\$94.4	\$3.8	\$127.8	131
1994	107.2	107.2	0.0	127.8	119
1995	118.2	117.4	+0.8	128.6	109
1996	122.5	131.1	-8.6	119.9	98
1997	129.5	146.4	-16.9	103.0	82
1998	132.5	161.1	-28.6	74.4	64
1999	136.6	178.7	-42.0	32.4	42
2000	142.6	200.3	-57.8	(5)	16

¹Ratio of assets in the fund at the beginning of the year to disbursements during the year.

²Figures for 1993 represent actual experience.

³Trust fund depleted in calendar year 2001.

⁴Trust fund depleted in calendar year 2004.

⁵Trust fund depleted in calendar year 2000.

NOTE: Totals do not necessarily equal the sums of rounded components.

In order to meet the test of financial adequacy in the short-range projection period, the ratio of estimated assets in the trust fund at the beginning of the year to estimated disbursements during that year must either (a) be at least 100 percent throughout the 10-year projection period, or (b) reach a level of 100 percent within 5 years and remain at or above 100 percent throughout the remainder of the 10-year period. In addition, the fund's estimated assets at the beginning of each month of the 10-year period must be sufficient to cover that month's estimated disbursements. This test is applied to the estimates under the intermediate assumptions for the period 1994-2003. Failure of the trust fund to meet this test is an indication that the solvency of the program over the next 10 years is in question and that action is needed to improve the short-range financial adequacy of the program. As can be seen from Table I.C4, this short-range test is not met. Under the intermediate assumptions, the trust fund ratio falls below the 100-percent level in 3 years and is exhausted in 7 years.

Figure 1 shows historical trust fund ratios for recent years and projected ratios under the three sets of assumptions. Figure 2 shows end-of-year trust fund balances for recent historical years and for projected years under the three sets of assumptions. On both figures, the labels "I," "II," and "III" indicate projections under the low cost, intermediate, and high cost alternatives, respectively.

Figure 1. SHORT-TERM HI TRUST FUND RATIOS

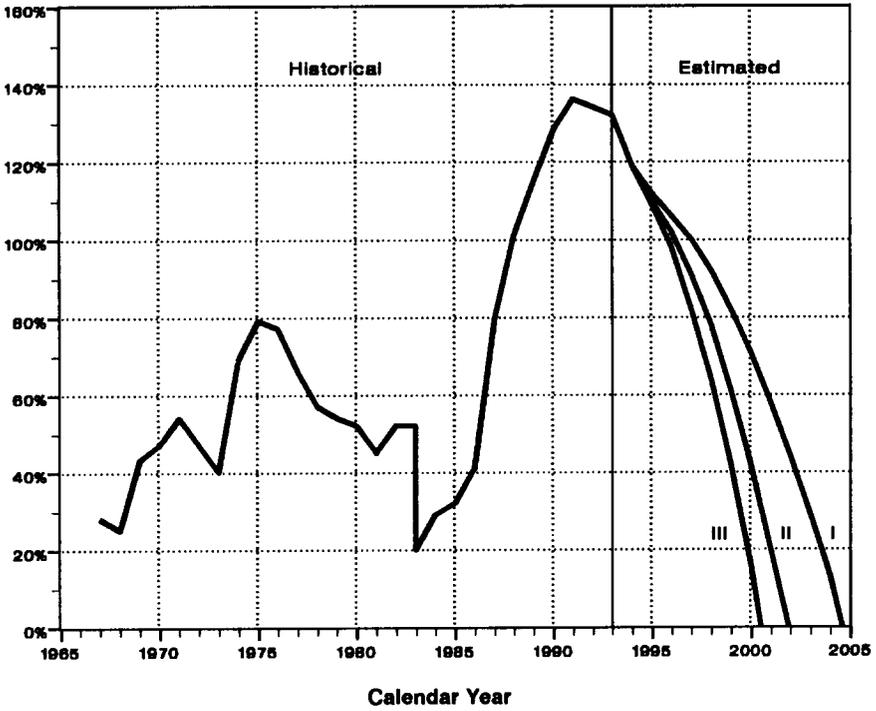
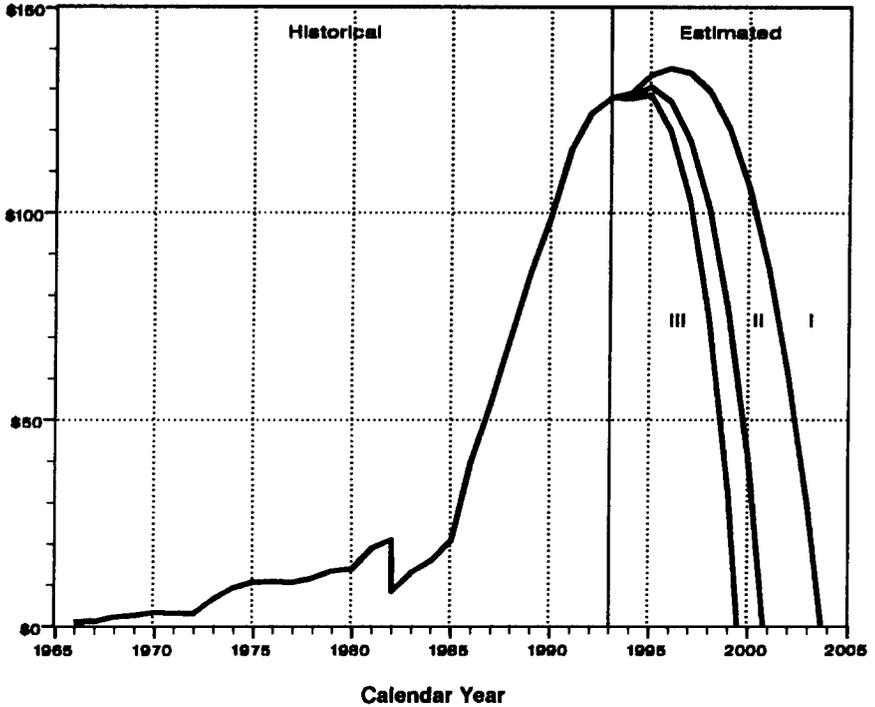


Figure 2. HI TRUST FUND BALANCE, END-OF-YEAR (in \$ Billions)



D. ACTUARIAL STATUS OF THE TRUST FUND

In the previous section (I.C), entitled "Expected Operations and Status of the Trust Fund", the expected operations of the HI program over the short-term period were presented. In this section, the actuarial status of the trust fund, or the adequacy of the scheduled financing to support program costs well into the future, is examined under all three alternative assumptions. The assumptions used in preparing projections are summarized in the technical section.

The adequacy of the current law financing schedule for the HI program on a long-range basis is measured by comparing on a year-by-year basis the income rates (from payroll taxes and income from taxation of OASDI benefits) with the corresponding incurred costs of the program, expressed as percentages of

taxable payroll. If these two items are exactly equal in each year of the projection period and all projection assumptions are realized, revenues will be sufficient to provide for program costs. In practice, however, tax rate schedules, which make up most of the income rate, generally are designed with rate changes occurring only at intervals of several years, rather than with continual yearly increases to match exactly with projected cost increases. To the extent that small differences between the yearly costs of the program and the corresponding income rates occur for short periods of time and are offset by subsequent differences in the reverse direction, the financing objectives can be met by maintaining an appropriate contingency reserve. In projecting costs under the program, only incurred expenditures (benefits and administrative costs) attributable to insured beneficiaries are considered, since benefits and administrative costs for noninsured persons are expected to be financed through general revenue transfers and premium payments rather than through payroll taxes.

The historical costs of the HI program, expressed as percentages of taxable payroll, are shown in Table I.D1. The ratio of expenditures to taxable payroll has increased from 0.94 percent in 1967 to 3.25 percent in 1993, reflecting both the higher rate of increase in program costs than in earnings subject to HI taxes and the extension of HI benefits to disabled and end-stage renal disease beneficiaries. The projected costs of the program under the intermediate assumptions, expressed as percentages of taxable payroll, and the income rates under current law for selected years over the 75-year period 1994-2068, are shown in Table I.D2. Further increases in the ratio of expenditures to taxable payroll under the intermediate assumptions result from the projection that the cost of the HI program will continue to increase at a higher rate than taxable earnings, as discussed later in this section. It can be seen from the selected years shown in Table I.D2 that, on a year-by-year basis, the income rates under current law are insufficient by a large margin to support the projected costs of the current program. As a result, the program is severely out of financial balance and prompt actions will need to be taken to increase revenues and/or reduce expenditures.

TABLE I.D1. -- COST OF THE HI PROGRAM, EXPRESSED AS A PERCENT OF TAXABLE PAYROLL

Calendar year	Expenditures under the program ¹
1967	0.94%
1968	1.04
1969	1.12
1970	1.20
1971	1.32
1972	1.30
1973	1.33
1974	1.42
1975	1.69
1976	1.83
1977	1.95
1978	2.01
1979	1.99
1980	2.20
1981	2.39
1982	2.65
1983	2.67 ²
1984	2.64
1985	2.63
1986	2.55
1987	2.45
1988	2.42
1989	2.66
1990	2.71
1991	2.75
1992	3.03
1993	3.25

¹Estimated costs attributable to insured beneficiaries only, on an incurred basis. Benefits and administrative costs for noninsured persons are expected to be financed through general revenue transfers and premium payments, rather than through payroll taxes. Gratuitous credits for military service after 1956 are included in taxable payroll.

²Deemed credits for military service before 1984 were attributed to the year in which such service had occurred. If all such credits had been attributed in 1983, expenditures under the program in 1983 would have been lower by 0.18 percent of taxable payroll.

TABLE I.D2. -- COST AND INCOME RATES OF THE HI PROGRAM, EXPRESSED AS A PERCENT OF TAXABLE PAYROLL ¹

Calendar Year	Expenditures under the program ²	Income Rates	Difference ³
1994	3.23%	3.02%	-0.21%
1995	3.32	3.02	-0.30
2000	3.92	3.03	-0.89
2005	4.52	3.05	-1.47
2010	5.03	3.08	-1.95
2015	5.80	3.13	-2.67
2020	6.63	3.19	-3.44
2025	7.56	3.24	-4.32
2030	8.46	3.28	-5.18
2035	9.15	3.31	-5.84
2040	9.55	3.32	-6.23
2045	9.80	3.33	-6.47
2050	9.99	3.34	-6.65
2055	10.24	3.36	-6.88
2060	10.57	3.38	-7.19
2065	10.96	3.39	-7.57
2068	11.20	3.40	-7.80

¹Under the intermediate assumptions.

²Estimated costs attributable to insured beneficiaries only, on an incurred basis, under the intermediate assumptions. Benefits and administrative costs for noninsured persons are expected to be financed through general revenue transfers and premium payments, rather than through payroll taxes. Gratuitous credits for military service after 1956 are included in taxable payroll.

³Difference between the income rates and program expenditures.

While the year-by-year comparisons discussed are necessary to measure the adequacy of the financing of the HI program, the financial status of the program is often summarized, over a specific projection period, by a single measure known as the actuarial balance. The actuarial balance of the HI program is defined to be the difference between the summarized income rate for the valuation period and the summarized cost rate (insured, incurred costs expressed as a percentage of taxable payroll) of the program for the same period. The present-value method is used to calculate summarized cost rates, income rates, and actuarial balances in this report, unless otherwise indicated. This approach is the same as that used in the OASDI report. Under the present-value method, the summarized income rates, cost rates, and actuarial balance are based upon the present values of future income on an incurred basis, future insured costs on an incurred basis, and future taxable payroll. The present values are calculated by discounting the future annual amounts, at the assumed rates of interest credited to the HI trust fund, to the beginning

of the valuation period. The summarized income and cost rates over the projection period are then obtained by dividing the present value of the taxable payroll into the present values of income and cost, respectively. The difference between the summarized income rate and cost rate over the long-range projection period, after an adjustment to take into account the fund balance at the valuation date and any target trust fund at the end of the valuation period, is computed to obtain the actuarial balance. In keeping with a decision by the Board of Trustees that it is advisable to maintain a balance in the trust fund equal to a minimum of one year's expenditures, the target trust fund balance is equal to the following year's estimated costs at the end of the 75-year projection period. It should be noted that projecting an end-of-period target trust fund balance does not necessarily insure that the trust fund will maintain such a balance on a year-by-year basis.

Calculating the fund balance under the present-value method is a convenient, generally accepted way of summarizing actuarial status. The actuarial balance computed under the present-value method can be interpreted as the immediate, level, and permanent percentage that must be added to the current law income rates and/or subtracted from the current law cost rates throughout the entire valuation period in order for the financing to support program costs and provide for the targeted trust fund balance at the end of the projection period. The income rate increase according to this method is 4.14 percent of taxable payroll. However, if income rates or cost rates were not changed until the year the trust fund falls below the 100-percent level recommended by the Board of Trustees, the level of the increase would have to be 4.34 percent of taxable payroll under the intermediate assumptions. If no changes were made until the year the trust fund will be exhausted, the actuarial deficit would be 4.59 percent of taxable payroll. The OASDI report also employs the present-value method of summarizing the long-term financial status of the Social Security program. An alternative way of calculating actuarial status under the modified average-cost method is presented in section III.A. The HI Trust Fund also fails the test of long-range financial adequacy using this method.

The actuarial balances under all three alternative sets of assumptions, for the first 25-year period, the first 50-year period, the entire 75-year period 1994-2068, and for each 25-year subperiod, are shown in Table I.D3. The summarized income rate for the entire 75-year period under the intermediate assumptions is 3.21 percent. The summarized cost of the program under the intermediate assumptions, for the entire 75-year period, is 7.35 percent of

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taxable payroll. As a result, the HI program fails to meet the Trustees' long-range test of financial adequacy, which is described in the OASDI report and the Glossary of this report, under any of the three sets of assumptions.

TABLE I.D3. -- ACTUARIAL BALANCES OF THE HI PROGRAM, UNDER THREE SETS OF ASSUMPTIONS

	Intermediate Assumptions	Alternative	
		Low Cost	High Cost
Projection periods:			
1994-2018:			
Summarized income rate	3.07%	3.05%	3.09%
Summarized cost rate ¹	4.68	3.70	5.99
Actuarial balance ²	-1.61	-0.65	-2.90
1994-2043:			
Summarized income rate	3.16	3.11	3.21
Summarized cost rate ¹	6.34	4.13	10.14
Actuarial balance ²	-3.18	-1.02	-6.93
1994-2068:			
Summarized income rate	3.21	3.14	3.29
Summarized cost rate ¹	7.35	4.46	12.55
Actuarial balance ²	-4.14	-1.32	-9.26
25-year subperiods:			
1994-2018:			
Summarized income rate	3.07%	3.05%	3.09%
Summarized cost rate ³	4.61	3.71	5.81
Actuarial balance ²	-1.54	-0.66	-2.72
2019-2043:			
Summarized income rate	3.27	3.19	3.35
Summarized cost rate ³	8.33	4.67	15.06
Actuarial balance ²	-5.06	-1.48	-11.71

TABLE I.D3. -- ACTUARIAL BALANCES OF THE HI PROGRAM, UNDER THREE SETS OF ASSUMPTIONS

	Intermediate Assumptions	Alternative	
		Low Cost	High Cost
2044-2068:			
Summarized income rate	3.36	3.23	3.55
Summarized cost rate ³	10.34	5.36	20.05
Actuarial balance ²	-6.98	-2.13	-16.50

¹Expenditures for benefit payments and administrative costs for insured beneficiaries, on an incurred basis, expressed as a percentage of taxable payroll, computed on the present-value basis, including the cost of attaining a trust fund balance at the end of the period equal to 100% of the following year's estimated expenditures, and including an offset to cost due to the beginning trust fund balance.

²Difference between the summarized income rate and the summarized cost rate.

³Expenditures for benefit payments and administrative costs for insured beneficiaries, on an incurred basis, expressed as a percentage of taxable payroll, computed on the present-value basis. Includes neither the trust fund balance at the beginning of the period nor the cost of attaining a non-zero trust fund balance at the end of the period.

The divergence in outcomes among the three alternatives is reflected both in the estimated operations of the trust fund on a cash basis (as discussed in section I.C) and in the 75-year summarized costs. The variations in the underlying assumptions, as shown in the technical section, can be characterized as (1) moderate in terms of magnitude of the differences on a year-by-year basis and (2) persistent over the duration of the projection period. During the first 25-year projection period, under the intermediate assumptions, program expenditures are projected to increase faster than taxable payroll, at a rate which gradually declines to about 2 percent more per year than taxable payroll by 2010. However, program expenditures are expected to grow at a rate of about 3 percent more than taxable payroll for the intermediate estimate in 2018, the last year of the first 25-year projection period. This is just after the major demographic shift, as described below, begins. Under the low cost alternative, program expenditures are also projected to increase faster than taxable payroll, but at a somewhat lower rate, which gradually declines to about 0.5 percent more per year than taxable payroll by 2010; the rate then increases, reaching about 1.0 percent more per year than taxable payroll in 2018. Similarly, the high cost alternative follows a pattern whereby program expenditures initially increase faster than taxable payroll and at a somewhat higher rate than under the intermediate assumptions, gradually declining to about 4 percent more than taxable payroll by 2010, and then increasing to about 5 percent more than taxable payroll in

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2018. Past experience has indicated that conditions producing results as adverse as those under the high cost alternative can occur. In view of this and because of the wide range of possible experience, it is important that a balance be maintained in the HI trust fund as a reserve for contingencies.

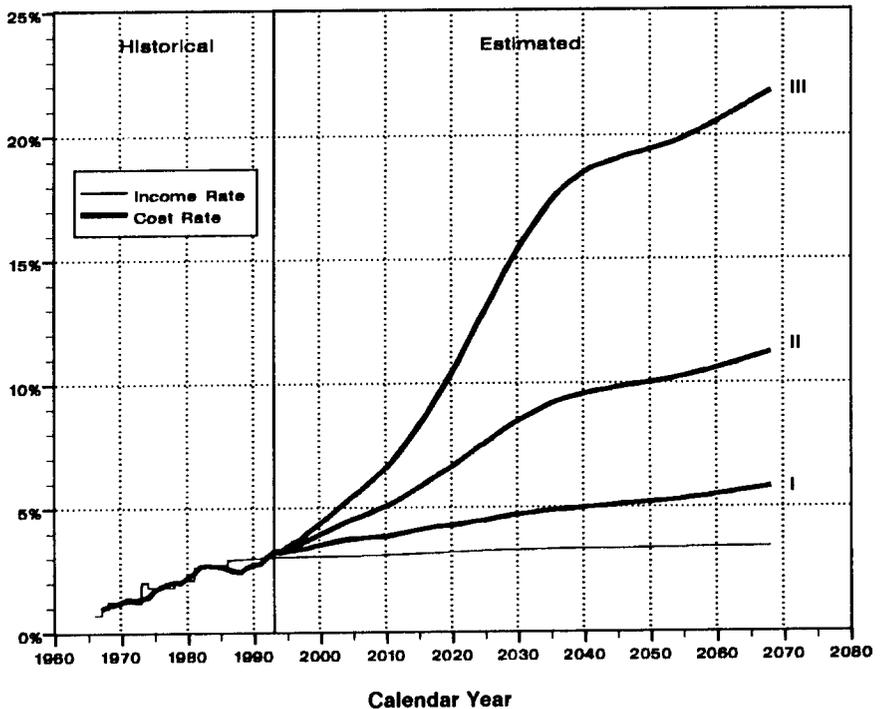
A valuation period of 75 years is needed to present fully the future contingencies that reasonably may be expected to occur, such as the impact of the large shift in the demographic composition of the population which occurs after the turn of the century. As Table I.D2 indicates, estimated expenditures under the program, expressed as percentages of taxable payroll, increase rapidly during the second 25 years of the projection period. This rapid increase in costs occurs because the relatively large number of persons born during the period between the end of World War II and the early 1960's (known as the "baby boom") will reach retirement age and begin to receive benefits, while the relatively smaller number of persons born during later years will comprise the labor force. During the last 25 years of the projection period, the projected increases in expenditures under the program stabilize.

Costs beyond the initial 25-year projection period for the intermediate estimate are based upon the assumption that costs per unit of service will increase at the same rate as that of average hourly earnings. Thus, changes in the last fifty years of the projection period primarily reflect the impact of the changing demographic composition of the population. Costs beyond the initial 25-year projection period for low cost and high cost alternatives begin by assuming that program cost increases, relative to taxable payroll increases, are approximately 2 percent less rapid and 2 percent more rapid, respectively, than the results under the intermediate assumptions. The 2 percent differentials gradually decrease until the year 2043 when program cost increases, relative to taxable payroll, are approximately the same as under the intermediate assumptions.

Figure 3 shows the year-by-year costs as a percent of taxable payroll for each of the three sets of assumptions, as well as the income rates. The income rates are shown only for the intermediate assumptions in order to simplify the graphical presentation and because the variation in the income rates by alternative is very small. The long-range summarized income rates for the low cost and high cost alternatives, for the 75-year valuation period, differ by only 0.15 percent of taxable payroll. By 2068, the annual income rates under the low cost and high cost alternatives differ by only about 0.4 percent of taxable payroll. Only small fluctuations are projected in the income rate, as the rate

of income from taxation of OASDI benefits varies only slightly for each alternative. Figure 3 illustrates the magnitude of the projected financial imbalance in the HI program by displaying the divergence of the program costs and income rates under each set of assumptions. On the figure, the labels "I," "II," and "III" indicate projections under the low cost, intermediate, and high cost alternatives, respectively.

Figure 3. ESTIMATED HI COSTS AND INCOME RATES AS PERCENT OF TAXABLE PAYROLL



The 75-year actuarial balance of the HI program, under the intermediate assumptions, is estimated to be -4.14, as shown in Table I.D3. The actuarial balance under the intermediate assumptions as reported in the 1993 Annual Report was -5.11. The major reasons for the change in the 75-year actuarial balance are summarized in Table I.D4. In more detail, these changes are:

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- (1) Changes in valuation period: Changing the valuation period from 1993-2067 to 1994-2068 adds a very large deficit year to the calculation of the actuarial balance. The effect on the actuarial balance is -0.13.
- (2) Legislation: Changes due to legislation described in the technical section result in a +1.31 change in the actuarial balance. The primary legislative items contributing to this improvement are the elimination of the contribution base and the addition of income from taxation of certain OASDI benefits.
- (3) Economic and demographic assumptions: Changes in the economic and demographic assumptions described in the technical section result in a -0.02 change in the actuarial balance. Most economic assumptions are less favorable.
- (4) Updating the projection base: The cost as a percent of payroll for 1993 was more than estimated in the 1993 report. The net effect of this change on the actuarial balance is -0.10.
- (5) Hospital assumptions: Changes in the hospital assumptions described in the technical section result in a -0.09 change in the actuarial balance. The primary factor contributing to this change is the higher DRG coding assumed for 1994.

TABLE I.D4. – CHANGE IN THE 75-YEAR ACTUARIAL BALANCE SINCE THE 1993 REPORT

1. Actuarial balance, intermediate assumptions, 1993 report	-5.11%
2. Changes:	
a. Valuation period	-0.13
b. Base estimate	-0.10
c. Legislation	+1.31
d. Economic and demographic assumptions	-0.02
e. Hospital assumptions	-0.09
f. Net effect, above changes	+0.97
3. Actuarial balance, intermediate assumptions, 1994 report	-4.14

E. CONCLUSION

The balance in the Federal Hospital Insurance Trust Fund at the beginning of 1994 was 119 percent of estimated outgo for calendar year 1994, above the minimum 100 percent level recommended by the Board of Trustees. However, the tax rates specified in the law are only sufficient, along with other income, interest earnings, and assets in the fund, to support program

expenditures only over the next 7 years, under the Trustees' intermediate assumptions. Also, the trust fund does not meet the short-range test of financial adequacy, which was described in a previous section of this report. Under all of the three sets of assumptions, the HI trust fund is projected to become exhausted within the next 6 to 10 years. Any significant adverse deviation from these projections could result in the inability of the fund to meet its obligations even sooner than projected.

Over the 75-year projection period, the income rate necessary to provide for benefits and administrative expenses far exceeds the income rate in the law in all years. The actuarial balance, as defined in the previous section (that is, including the cost of attaining a trust fund balance at the end of the period equal to 100% of the following year's estimated expenditures, and including an offset to cost due to the beginning trust fund balance), is -1.61 for the first 25-year projection period, -3.18 for the first 50-year projection period, and -4.14 over the entire 75-year projection period, under the intermediate assumptions. The actuarial balances for the 25-year subperiods, as defined in the previous section (that is, including neither the trust fund balance at the beginning of the period nor the cost of attaining a non-zero trust fund balance at the end of the subperiod), are -1.54, -5.06, and -6.98 for the first, second, and third 25-year subperiods, respectively, under the intermediate estimate assumptions. The trust fund does not meet the Trustees' long-range test of financial adequacy, which is defined in the OASDI report and the Glossary of this report, under any of the three sets of assumptions. In order to bring the HI program into actuarial balance even for the first 25-year projection period under the intermediate assumptions, either outlays will have to be reduced by 34 percent or income increased by 52 percent (or some combination thereof).

Currently about four covered workers support each HI enrollee. This ratio will begin to decline rapidly early in the next century. By the middle of that century, only about two covered workers will support each enrollee. As the post-World War II "baby boomers" become eligible for benefits, the annual rate of increase in program costs as a percentage of taxable payroll rises substantially, from about 2 percent in 2010 to 3 percent in 2015 under the intermediate assumptions. Not only are the anticipated reserves and financing of the HI program inadequate to offset this demographic change, but under all the assumptions the HI trust fund is projected to become exhausted even before the major demographic shift begins to occur. Exhaustion is projected to occur around the turn of the century, in 2001 under the intermediate

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assumptions, and could occur as early as 2000 if the high cost assumptions are realized.

The Trustees note that some steps have been taken to reduce the rate of growth in payments to hospitals, including the implementation of prospective payment and diagnosis-related groups. Initial experience under the prospective payment system for hospitals suggests that this payment mechanism may be an effective means of constraining the growth in hospital payments and improving the efficiency of the hospital industry. Nonetheless, projected costs for the HI program far exceed projected revenues over the 75-year long-range period. As a result, the HI program is severely out of financial balance and the Trustees believe that Congress must take timely action to fundamentally reform the HI program and control related program costs.

Even though the long-range status of the HI program has improved somewhat since last year's report, it has deteriorated over recent years as measured by the actuarial balances. In addition, the HI trust fund fails to meet the short-range test of financial adequacy and is projected to experience increasing annual deficits in future years, beginning in calendar year 1996. In view of the poor financial condition of the HI trust fund and the failure of the fund to meet the short-range test of financial adequacy, the Board of Trustees is again alerting the Congress of the unfavorable financial status of the HI trust fund.

The cost of the HI program is projected to increase from 1.5 percent of GDP in CY 1993 to 4.9 percent of GDP in CY 2065. This rapid growth is attributable primarily to (1) increases in hospital admissions, (2) increases in reported case mix, and (3) changes in demographics. With the magnitude of the projected actuarial deficit in the HI program and the high probability that the HI trust fund will be exhausted around the turn of the century, the Trustees urge the Congress to take additional actions designed to control HI program costs through specific program legislation and as a part of enacting comprehensive health care reform. The Trustees believe that prompt, effective, and decisive action is necessary.